FISCAL AWARENESS SERVICE

Policy Paper Series

POLICY PAPER #5 October 3, 1986

FEDERAL TAX REFORM: OPTIONS FOR THE STATE

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One result of federal tax reform will be a windfall revenue gain to states in which taxpayers calculate their state income tax on the basis of their federal adjusted gross income (AGI). Changes in the federal treatment of such items as capital gains and IRAs will increase taxpayers' adjusted gross income. Because the higher AGI multiplied by the current state tax rate will yield extra state revenue, Michigan is expected to gain about $150 million to $175 million from these changes. Debate is under way in affected states as to how these monies should be used. For Michigan, the following five options appear most reasonable from both practical and tax policy standpoints:

- Retain the revenue for budget purposes
- Reduce the state income tax rate
- Increase the personal income tax exemption
- Eliminate the sales tax on utilities
- Provide additional property tax relief

Retain the Revenue

This option is not likely to be popular with the public, but can be justified on the grounds that state and local governments need additional funds to make up federal budget cuts. The Reagan strategy has been to cut taxes at the federal level and transfer responsibilities to state and local governments. His argument is that lower federal taxes will allow state and local governments to raise their taxes to pay for these new responsibilities. This is not always feasible politically, therefore new revenues should not be given away too quickly. A variation of this option would be to allocate all or a portion of these funds to the budget stabilization fund.

Reduce the State Income Tax Rate

This option is receiving considerable legislative support and would likely meet with considerable public support. Governor Blanchard already proposed using the windfall to reduce the state income tax from 4.6 percent to 4.4 percent; Senate Republicans upped the ante and proposed reducing the rate to 4.2 percent. William Lucas's tax program calls for reducing the rate to 4.0 percent. Each 0.1 percent reduction equals about $82 million.

Supporters of income tax rate reduction argue that the rate was raised for two and one-half years to restore fiscal stability to the state and any available funds should be used to provide relief to the taxpayers who paid the higher rates. Also, the personal income tax may influence business location decisions, and lowering the rate may make the state more attractive to business executives.

On the negative side, this option does little to improve the state's fiscal stability or tax structure because it simply returns money to the taxpayer on a pro rata basis. Moreover, as indicated in Table 1, a reduction of 0.2 percent in the tax rate would be more favorable to high-income taxpayers than would a $500 increase in the personal exemption, thus providing less progressivity. For example, for a family of four the 0.2 percent tax rate reduction would provide more relief for taxpayers earning more than $52,000, while the exemption increase would provide more relief for taxpayers earning less than $52,000.

Increase the Personal Income Tax Exemption

The personal exemption could be increased from $1,500 to $2,000 at a cost to the state of about $175 million in lost revenue, about $10 million more than the cost of a 0.2 percent reduction in the state income tax rate. Three arguments support this option. First, the increase in the standard deduction and the personal exemption on the federal income tax will create a situation in which as many as 500,000 taxpayers will be exempt from the federal income tax but still subject to the Michigan income tax, causing administrative as well as political problems. Increasing the state personal exemption by $500 would reduce this number by about 100,000.

Second, the Michigan personal exemption has not been increased since 1973; adjusted for inflation, the current $1,500 exemption is now worth $634 in 1973 dollars. The federal income tax as well as the income tax in a number of other states have been indexed to inflation, and Michigan should also periodically adjust its credits and exemptions for inflation.

Third, an increase in the personal exemption would improve the progressivity of the income tax by reducing taxes proportionately more for low-income taxpayers than for high-income taxpayers. The increase in the personal exemption would favor large, low- and moderate-income families, while a rate reduction would be more beneficial for small, high-income families.

Eliminate the Sales Tax on Utilities

This option would markedly improve the equity of the tax structure, but may not generate much excitement in the legislature or with the public. In general, the sales tax is regressive because low-income persons spend a larger share of their income than high-income persons and, therefore, pay a higher portion of their income for sales taxes. The sales tax on utilities is the most regressive component of the tax. As indicated in Table 2, expenditures for utilities take a much greater share of the budget of low-income taxpayers than of high-income taxpayers; 9.8 percent for the lowest 20 percent income group and 6 percent for the highest 20 percent.[1] Removing the sales tax on utilities would reduce the regressivity of the tax. (In 1974, voters removed the sales tax on food and drugs by a 56 to 44 percent vote.)

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[1] These data actually understate the regressivity of the sales tax on utilities. The best measure would be to calculate expenditures as a share of income, but because all sources of income are not reported, this calculation cannot be made. Note that for the lowest 20 percent income group, expenditures are several times reported income. This is because income such as gifts and loans are not reported.

TABLE 1

Tax Savings From a 0.2 Percent Income Tax Reduction
Compared With $500 Increase in Personal Exemption

	Family Size									
	1		2		3		4		5	
Income	$500 Exemption	0.2% Reduction	$500 Exemption	0.2% Reduction	$500 Exemption	0.2% Reduction	$500 Exemption	0.2% Reduction	$500 Exemption	0.2% Reduction
$ 5,000	$23[a]	$ 7	$46	$ 4	$69	$ 1	$ 0	$ 0	$ 0	$ 0
10,000	23	17	46	14	69	11	92	8	115	5
15,000	23	27	46	24	69	21	92	18	115	15
20,000	23	37	46	34	69	31	92	28	115	25
25,000	23	47	46	44	69	41	92	38	115	35
35,000	23	67	46	64	69	61	92	58	115	55
50,000	23	97	46	94	69	91	92	88	115	85
100,000	23	197	46	194	69	191	92	188	115	195

SOURCE: Calculated by Public Sector Consultants, Inc.

NOTE: The revenue cost to the State of the $500 exemption is slightly higher than the cost of the 0.2 percent reduction. Therefore, the income levels at which tax savings from the reduction and exemption are equal are slightly lower than indicated in the table.

[a]This figure is calculated by multiplying $500 x 4.6, the current state income tax rate.

TABLE 2

Consumer Expenditures by Category as Share of Total Consumer Expenditures, by Income Class: 1984

	All Consumer Units	Lowest 20%	Second 20%	Third 20%	Fourth 20%	Highest 20%
Income before taxes	$24,578	$ 3,577	$10,828	$19,297	$30,370	$58,639
Annual expenditures	22,149	11,347	13,864	18,981	25,525	40,935
Food	16.6%	20.2%	19.2%	17.9%	16.4%	14.4%
Shelter	16.9	19.6	17.7	17.4	16.3	16.1
Utilities	*7.5*	*9.8*	*9.7*	*8.5*	*7.1*	*6.0*
Household operations and other	5.5	5.1	4.7	5.0	5.4	6.2
Apparel and services	5.5	5.4	4.8	5.2	5.0	6.1
Transportation	20.1	17.2	19.9	21.1	20.8	20.2
Health care	4.1	5.0	6.1	4.8	3.6	3.2
Entertainment	4.9	4.0	3.9	4.4	5.0	5.5
Personal insurance and pensions	9.9	3.8	5.1	7.9	11.6	13.1
Other[a]	8.9	9.8	9.0	7.8	8.9	9.2
TOTAL	99.9%	99.9%	100.1%	100.0	100.1%	100.0%

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey, June 1986.

[a]Includes personal care, education, tobacco, and cash contributions.

Another argument in favor of this option is that beginning next year the sales tax will not be deductible for federal tax purposes while the income tax will be deductible. Therefore, the net cost of the sales tax on utilities will increase for itemizers next year.

In fiscal year 1984-85, the sales and use tax on utilities generated $205 million for the State. However, only about 40 percent or $82 million of this amount was paid by residential users. In this paper, the option is limited to residential users because the tax options under discussion are aimed at individuals rather than businesses. One could make the case, however, that the sales tax on utilities paid by businesses is passed on to their customers and that reducing business taxes will foster economic development; therefore, the sales tax should be removed for businesses as well as individuals. If the relief were limited to residential users, sufficient revenues would still be available to allow an increase in the personal exemption of $300 or a reduction of the income tax rate by .13 percent.

There are two major arguments against eliminating the sales tax on utilities. First, the average benefit per person would be barely noticeable. For example, on a $100 monthly utility bill the saving would be only $4. Second, federal tax reform will result in higher state income taxes for most taxpayers and any relief granted should be on the state income tax.

<u>Provide Additional Property Tax Relief</u>

This option has a number of advantages. First, the property tax is the most unpopular tax used by state and local governments[2] and, compared to other states, Michigan's property tax burden is much higher than its sales or income tax burden. Second, federal budget cuts will affect local governments much more than state governments, and local governments have fewer revenue sources. State-financed property tax relief would make it easier for local governments to raise property taxes to pay for responsibilities no longer financed by the federal government.

There are three basic ways for the State to provide property tax relief. First, the current homestead property tax credit against the state income tax could be expanded by making the formula more generous and/or increasing the $1,200 maximum. Improvements in the formula have been proposed by the governor and a number of legislators. Second, the State could set up a fund to finance a gradual reduction in millage rates. A one-mill reduction would cost about $106 million annually. Third, the constitution could be amended to limit property taxes to a percentage of market value, as William Lucas has proposed.

The major disadvantage of this option is that total property tax revenues are so high that $150 million to $175 million in relief would make only a small dent in the burden. Also, the tax credit alternative suffers from a lack of

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[2] In a 1986 poll conducted by the Advisory Commission on Intergovernmental Relations, 28 percent of the respondents selected the property tax as the worst tax, second only to the federal income tax, which was selected by 37 percent. The state income tax and the state sales tax were selected as the worst tax by 8 percent and 17 percent of the respondents, respectively. Advisory Commission on Intergovernmental Relations, "Changing Public Attitudes on Government and Taxes," 1986, S-15, Washington, D.C., Table 4.

visibility and can be criticized for providing an incentive for local governments to increase property taxes. The millage reduction alternative would cover both residential and business property and would provide limited relief, but to have much effect, additional revenues would be needed to finance annual reductions in the millage rate. The limitation to a percentage of market value suffers from the same problem as the millage reduction alternative.

Conclusion

When the election is over and we have the relative political calm of the governor and state senators in office for four years and the state representatives for two, policy makers should take a fresh look at the future of Michigan. This state has made considerable progress in improving its economy and the fiscal stability of state government. However, in view of the large federal deficits and uncertainly about Gramm-Rudman, the economy is still precarious and our state is more vulnerable than most. Needed are policies that will give us advantages over our competitors and increase our resistence to recessions. Such a policy is the prudent use of the windfall revenues. If we opt for short-term political gain, the future of our state will be harmed.

There are a number of ways that windfall revenues from federal tax reform could be used. These monies could be retained by the State and used to finance new programs (including grants to local governments), replace federal funds, or increase the budget stabilization fund. The monies also could be returned to taxpayers through income, property, or sales tax relief. All the options have important advantages. In our opinion, the best options in terms of tax equity and fiscal stability--in order of preference--are to

1. increase the personal income tax exemption by $500,

2. eliminate the sales tax on utilities for residential users and increase the personal exemption by $300, or

3. allocate the money to the budget stabilization fund until the fund balance is 10 percent of general fund-general purpose and school aid fund expenditures.

All three options would help correct weaknesses in Michigan's fiscal structure. It is our hope that, in legislative debate about the issue, the tax policy considerations outlined here will be given equal weight with political considerations.